

CAN THE UNITED STATES AFFORD THE TAX CUTS OF 2001?

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There are a number of reasons to doubt the wisdom of the tax cuts and other fiscal policy changes of 2001, ranging from their adverse effects on long-term interest rates to their implications for the solvency of the Social Security and Medicare programs. Those problems will be addressed by other members of the panel and I will focus my own remarks on one other, largely neglected, aspect of the issue: the very adverse impact of those fiscal policy changes on the international economic position of the United States. This is a policy panel so I will start by summarizing my major conclusions and policy recommendations:

1. The tax cuts of early 2001 will reduce government saving by about 2 percent of GDP per year when they are fully implemented. Spending increases decided both before and after September 11 add at least another 0.5 percent of GDP to that reduction. Any additional “fiscal stimulus” measures would further increase that total.
2. Even allowing for expected offsets via increased private saving, whose magnitudes are highly uncertain in light of the experience of the last 20 years, the structural US current

account deficit may thus rise by another 1 to 1½ percent of GDP or about \$100 billion to \$150 billion per year.

3. That external imbalance had already reached 4½ percent of GDP before the current recession, requiring the United States to import about \$4 billion of foreign capital every working day on top of a net foreign debt position that already exceeds \$2 trillion. The deficit is likely to rise by another full percentage point or more of GDP for purely cyclical reasons over the near term as the United States leads the recovery from the global turndown. It is already well into the “danger zone” where corrections have been forced on the United States on several occasions (and on numerous other industrial countries) in the past and was labeled “unsustainable” by both Chairman Greenspan (Greenspan 2001) and the IMF (IMF 2001 b) in late 2001.

4. The tax cut and spending decisions of 2001 have thus increased the risk of a sharp fall in the exchange rate of the dollar that would push up US inflation and interest rates, drive down the stock market, and jeopardize the economic recovery. The tax cuts could in fact turn out to be the proverbial “straw that broke the camel’s back” and should be rescinded, or at a minimum frozen at the levels already implemented, as soon as the economy has clearly recovered (probably by 2003) just as a number of individual states (including Governor Jeb Bush’s Florida) are already rescinding or freezing tax cuts that turned out to be unaffordable for them. No further “fiscal stimuli” should be adopted.

The US Fiscal and Current Account Positions

The latest example of American “benign neglect” of the country’s international economic position was last year’s debate over the tax cut legislation, which addressed a wide range of issues but totally ignored the proposal’s implications for our external deficits (despite my own futile efforts in Bergsten 2001a, 2001b and 2001c). Such neglect is badly misplaced. The share of international transactions in the US economy has tripled over the past 40 years and now exceeds 30 percent of GDP, a much higher rate than in Japan and about the same as for the united Europe. Moreover, the international effects of the tax cut legislation could turn out to be among the most important that it will generate.

The Congressional Budget Office has estimated that the legislation would weaken the federal fiscal position by about \$1.8 trillion over the period 2001-2011 (CBO 2001). About \$1.2 trillion of this total derives from the direct impact of the tax cuts and most of the remainder stems from the increase in debt service costs on the higher level of federal debt that remains from those reduced surpluses. Other analysts, noting the accounting gimmicks used to hold down the apparent costs of the package, suggest that its real budget cost is likely to be \$2.3 trillion (Kogan and Greenstein 2001).¹

Whoever’s estimates are used, the net impact will be to weaken the federal budget position by about 2 percent of GDP per year, with smaller effects (probably about 1 percent of GDP) in the earlier part of the decade and the full steady-state amount eventuating by the end of the period. Since the budgetary costs for the coming decade were deliberately limited by a combination of long phase-ins, delayed startups and unrealistic termination provisions, the long

¹ The CBO analysis in August 2001 further reduced the projected budget surpluses, due to economic and technical changes, but this paper is limited to the impact of the tax cut and spending legislation.

term impact will clearly be at least 2 percent of GDP per year. The director of OMB admitted in November 2001 that, as a result, the unified budget would be in deficit for at least the next three years. The problem for the US economy is that a large part of this shift will have to be financed by the rest of the world.

The current account position of course equals national savings minus national investment. The policy-induced decline in government saving would, *ceteris paribus*, produce a similar decline in total national saving. In practice, of course, all other things are not equal. We would in fact traditionally expect a rise in private saving that would offset some, perhaps a significant, part of the fall in government saving.

During the past two decades, however, the record has not been encouraging. Household (and total private) saving declined sharply just as government saving turned sharply negative in the 1980s. It fell further during the 1990s, by almost as much as government saving rose.²

Hence it is unclear whether the reduction in government saving generated by the tax and spending legislation of 2001 will be substantially offset by a pickup in private saving. (It could of course also be offset by a decline in private investment but that would be a decidedly undesirable outcome and presumably was not an objective of the tax legislation.) Prudence suggests that we assume that the net effect of the tax legislation will be to increase the US current account deficit by at least 1-1½ percent of GDP per year (\$100 billion to \$150 billion at current levels).

² These calculated private saving rates of course exclude the impact of capital gains and other economic considerations that cause well known statistical and conceptual problems.

The Current Account Problem

This new fiscal deterioration represents a potentially major problem for the US economy because our current account deficit has already reached record levels. The deficit rose by more than 1 percent of GDP (about \$100 billion) in each of the three successive years 1998-2000, a clearly unsustainable path that was far worse than the unsustainable path of the mid-1980s that led to a fall of 50 percent in the exchange rate of the dollar in 1985-87. The deficit reached 4½ percent of GDP (\$450 billion) in 2000. It fell a bit in 2001 due to our recession, probably to about 4 percent of GDP, but cyclical factors are likely to drive it to new heights in 2002 and beyond as the United States leads the recovery from the present global downturn. Some forecasters expect the deficit to climb again by another 1 percent of GDP in 2002, and perhaps another ½ percent in 2003, taking it well beyond 5 percent of GDP.

Research at both the Federal Reserve Board and the Institute for International Economics reveals that industrial countries, including the United States, enter a “danger zone” of current account unsustainability when their deficits reach 4-5 percent of GDP (Freund 2001, Mann 1999). At these levels, corrective forces tend to arise either spontaneously from market forces or by policy action. For the United States, the large previous adjustments in the early 1970s, late 1970s, and mid-1980s occurred—mainly via substantial depreciation of the dollar—with the current account deficit at considerably lower levels.

The further fiscal deterioration implied by the tax cut legislation of 2001 could thus push the external deficit well beyond the “danger zone” and could turn out to be “the straw that breaks the camel’s back.” Even at current levels, the United States must attract net capital imports of more than \$2 billion every working day to finance the deficit. Moreover, since US capital

exports have been running at rates about equal to the current account deficit, we must sustain gross capital inflows of over \$4 billion per working day.

These flow requirements come on top of a US net international investment position that already exceeded a negative \$2 trillion at the end of 2000 and is on a trajectory to reach 40 to 50 percent of GDP within the next few years (Mann 1999). Gross foreign holdings in dollars exceeded \$9 trillion at that time so that even a slight sell-off from the current stock, especially in addition to any foreign reluctance to pump in the additional daily requirement of \$4 billion, could produce a sharp fall in the exchange rate of the dollar. American residents could of course join any such sell-off so the potential for a sharp depreciation—as has in fact occurred about once per decade in the postwar period, most recently in 1995 when the dollar hit its all-time record lows against both the DM and yen—is obvious.

The Risks for the US Economy

To restore a sustainable equilibrium in the US current account, the trade-weighted average exchange rate of the dollar would probably need to fall by at least 20 percent.³ This is the amount of overvaluation revealed by studies of the “fundamental equilibrium exchange rate” for the dollar (Wren-Lewis 1998) and implied by the IMF in its most recent analysis (IMF 2001a). Such a correction would cut the external deficit by \$100 billion to \$200 billion and bring it back at least a bit below the danger threshold. In practice, of course, exchange rates tend to overshoot so the actual depreciation could be much greater for at least a while.

Such a plunge of the dollar, especially if it were to occur precipitously rather than over a more prolonged period of time (IMF 2001a), could adversely affect the US economy in at least

three ways. First, inflation pressures would result. Every 10 percent fall in the trade-weighted exchange rate of the dollar tends to increase the US price level by about 1 percent over a two- to three-year period.

Second, interest rates would rise. Nominal rates would presumably increase at least with inflation. Real rates would probably rise too, as foreign (and perhaps domestic) investors sought higher returns to offset the (newly) perceived risk of further depreciation and as the Federal Reserve tightened monetary policy in response to the inflationary impulse. Hence market rates could climb by 300 basis points or more in the wake of a dollar depreciation of even 20 percent.

Third, the stock market would presumably fall again, perhaps sharply, as a result of both the inflation and interest-rate developments. Negative wealth effects would add to the adverse impact on the economy.

Hence the US economy could suffer a triple hit from the sharp fall in the dollar that could ensue, at almost any time, from the further increase in the current account deficit that will be exacerbated by the tax and spending legislation of 2001 (especially in light of the likely cyclical developments over the next year or so). The IMF has in fact estimated that such a scenario, if it were to occur precipitously, could take 1½ percentage points off annual US economic growth for the next two years and have continuing negative effects for at least two or three years more (IMF 2001a). If the tax cuts were to contribute to such an outcome, they could wind up hurting rather than helping the US economy.

It should be noted that the huge Reagan tax cuts, and the associated increase in budgetary expenditures (mainly for defense), had similar effects on the economy in the early 1980s. Interest rates soared and the dollar appreciated for a while, producing a huge deterioration in the US

³ This would imply appreciations of considerably more than 20 percent for the euro, and probably the yen, because the economies of some of America's most important trading partners (e.g., Canada and Mexico) could not be

current account position—from balance in 1980 to a deficit of almost 4 percent of GDP in 1985—and an eventual fall of 50 percent in the exchange rate during 1985-87. A key difference between that period and today, however, is that the United States entered the 1980s as the world's largest creditor country whereas we begin the 21st century as the world's largest debtor country. The tax cuts of the 1980s were thus financed, to a considerable extent, by running down the international asset portion that the United States had accumulated over the previous six decades. Today, by contrast, we are already largely dependent on foreign capital and thus the risk of relying on more is correspondingly much greater.

Policy Implications

Several policy implications derive from this analysis. At a minimum, the United States (and its G-7 partners) should take whatever steps they can to avoid any further strengthening of the dollar. Despite the prospects for an ultimate sharp depreciation, the dollar could rise further before it falls—perhaps over the next year or so if the United States does indeed lead the recovery from the current global slowdown. Such a disequilibrating further spike in an already overvalued dollar occurred in 1984-85, and produced such an internal protectionist response in the United States that the Reagan administration had to reverse its initial policy and actively drive the dollar down through the Plaza Agreement.

In such circumstances, the G-7 should “lean against the wind” in the exchange markets to minimize the further buildup in the US deficit. If conducted properly, such policies can clearly work as revealed in all three cases of intervention by the Clinton administration: to halt the excessive appreciation of the yen (to 80:1 against the dollar) in 1995, to halt the excessive depreciation of the yen (to 150:1 against the dollar) in 1998 and to halt the excessive

expected to rise that much.

depreciation of the euro (to 84 cents against the dollar) in 2000 (see also Dominguez and Frankel 1993 and Catta *et al.* 1994).

In addition, US officials should abandon the “strong dollar” mantra of 1995-2000 in order to signal the markets that they recognized that the dollar was overvalued and were prepared to accept an orderly depreciation (Bergsten 2001d, 2001e). This rhetoric has clearly had an impact on the markets and should be modified. It is encouraging that neither Secretary of the Treasury Paul O’Neill nor any other US official has reiterated the phrase “strong dollar” since September 11.

Moreover, Japan should be compelled to halt its current policy of competitive depreciation of the yen. Japan intervened massively in the currency markets to keep the yen from appreciating further in the fall of 2001 and has aggressively talked its currency down over the past couple of months. As a result, the yen has weakened steadily beyond 130:1 and is now far below its FEER. Japan apparently despairs restoring economic growth through any of the necessary domestic policies, such as fundamental reform of the banking system or more effective monetary policy, so is attempting to export its problems by promoting renewed growth of its trade surplus—a policy every bit as unsustainable, because of its repercussions on other countries, as its futile efforts in the past to spend its way back to growth by building roads and bridges to nowhere (Bergsten, Ito, and Noland 2001).

China, Korea, and other competitors in East Asia are of course deeply affected by these moves. As in the wake of the Asian crisis in 1998, they are thus threatening to match the yen move with depreciations of their own if it goes much further. Every 1 percent fall in the yen-dollar rate adds \$1 billion to the US bilateral trade deficit with Japan (Cline 1995), so the Japanese action further intensifies our own imbalance as well. Japan’s actions are wrong in both

domestic and international terms and should be opposed in no uncertain terms by the United States and the rest of the G-7.

The more fundamental responses to the US external imbalance lie of course in the economic fundamentals in the United States and its major trading partners. It is thus very important to the United States that Europe and Japan address their underlying productivity problems, achieve faster expansion and thus achieve more balanced global growth in the recovery cycle. This will require more aggressive fiscal and monetary expansion measures in Europe, a comprehensive restructuring of the banking system in Japan, and attacks on underlying structural rigidities in both. Such measures are highly desirable in the short run, to provide a synchronized global response to the first synchronized global downturn in almost 30 years, but failure to achieve more balanced growth for the medium run could also lead to the “hard landing” scenario described above and truncate the US and global recoveries.

The United States must, at the same time, reduce the gap between its national saving and national investment. It should not do so by reducing investment since capital deepening has been such an essential element in the achievement of higher productivity levels in the second half of the 1990s. One major risk of the tax cut legislation of 2001 is of course that, by inducing higher long-term interest rates, it will reduce investment and thus weaken the prospects for future growth.

Hence it is imperative for the United States to raise the rate of domestic saving. Unfortunately, we do not know how to increase private saving—although, because of the high payoff from doing so, it would be desirable to experiment with such ideas as substituting a consumption tax for at least part of the income tax and mandatory saving schemes linked to Social Security reform.

The only clear bottom line remains the need to maximize government saving through running steady and sizable surpluses in the federal government budget. As a result of the several tax reforms of the early 1990s and the booming economy of the later 1990s, such surpluses were achieved and, less than a year ago, seemed to be assured for the foreseeable future.

The tax reduction legislation of 2001 eliminated a significant share of those surpluses. Its only possibly redeeming benefit for the economy, which was not foreseen when it was initially proposed, is to provide a modest stimulus to promote recovery from the current recession. Hence the tax cuts should be rescinded, or at least frozen, as soon as recovery is clearly in place, probably starting in 2003 (see also Tyson 2001).⁴

It should be noted that several of our individual states have already altered tax cuts that were passed in the flush of economic boom but now turn out to be unaffordable. For example, Jeb Bush's Florida has already postponed the sharp reduction in its "intangibles tax" on investor-owned securities and Jim Gilmore's Virginia has likewise postponed the phase out of its "car tax." Even the Reagan administration worked with the Congress in 1982 to rescind about one-third of its tax cuts of the previous year when it immediately became apparent that they were much too large (Orszag 2001).

The result of such a midcourse correction would be to limit the further deterioration of the saving-investment balance in the United States, a further increase in our current account deficit and the increased likelihood of a "hard landing" for the dollar that would severely weaken the US (and world) economy. Doing so would increase the prospect that the inevitable correction of the external imbalance could be achieved in a more gradual and orderly manner. This latest episode of US "benign neglect" of its international economic position could be the most costly

⁴ An early proposal to freeze all future phase-ins of the tax cuts is in Citizens for Tax Justice 2001. However, this would recoup less than half the decline in government revenue generated by the legislation of 2001.

yet and I would therefore urge that action be taken promptly to minimize the enormous risks that are involved.

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